AMERICAN ACADEMY *of* ACTUARIES

Mr. Louis Felice
Chair, NAIC Capital Adequacy Task Force
New York State Insurance Department
One Commerce Plaza 19th Floor
99 Washington Avenue
Albany, NY 12257

June 2, 2010

Re: Proposed Increase to Commercial Real Estate Mortgage Risk Based Capital

Dear Lou:

The American Academy of Actuaries[1] Invested Assets Work Group (AIAWG) is a work group of the American Academy of Actuaries' Life Capital Adequacy Subcommittee (LCAS). The AIAWG is charged with monitoring and responding to life insurance industry investment practices with respect to appropriate risk based capital treatment.

The AIAWG appreciates the opportunity to comment on the proposed changes to the Risk-based Capital formula by the NAIC's Capital Adequacy Task Force (CADTF) related to capital requirements for Commercial Real Estate Mortgage Loans (CREMs). *While the AIAWG understands the concerns arising from the deterioration in the overall commercial mortgage market, the AIAWG does not support the CADTF's proposed increase to the RBC requirements for 2010. Our opposition to the proposal is based on the following:*

1. The proposal isn't supported by sufficient observed data for life insurers, but rather, appears to be driven more by the deteriorating loss experience for the entire commercial mortgage loan sector. Before increasing the capital requirements for commercial mortgage loans, further analysis of life insurers' loss experience by loan type is needed to properly determine if changes to the RBC factors are justified. While anecdotal evidence points to increasing losses in life insurers' commercial loan portfolios in 2009, the risk based capital requirements should be increased only if the deterioration in experience is determined to be permanent and worse than the loss experience anticipated in the current RBC factors.

2. The proposal attempts to fine tune RBC in a manner inconsistent with the methodology used to derive the current RBC factors. RBC factors are intended to set aside a sufficient amount of capital to cover the worst level of losses, at a given confidence level, measured over a business cycle or a specified number of years. During that time period, losses will reach a peak and trough and the RBC factors are derived to cover losses over the entire period. RBC factors are not intended to provide the total cushion against loss.

[1] The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States

3. The proposal introduces pro-cyclicality to the RBC formula that is not present in any other elements of the formula and is inconsistent with the intended design of the formula. The RBC formula establishes <u>minimum</u> capital requirements that an insurer must maintain at all times.

In the following sections, we expand upon our concerns with the CADTF's proposal in more detail.

Insufficient Supporting Data

While considering the impact of worsening CREM experience on capital requirements is commendable, the AIAWG is concerned that this recommendation to significantly increase the CREM capital requirements is based more on the expectation of worsening experience for the entire commercial mortgage sector rather than observed experience for life insurers' portfolios. In fact, many life insurers are reporting only modestly increasing delinquencies, contradicting the perception that life insurers' loss experience is rapidly worsening.

Recent loss experience in the CREM market has been analyzed in three studies:

a. Moody's Insurance Special Comment (December 2009):
   U.S. Life Insurers' Commercial Mortgage Exposure & Losses Are Manageable
b. Moody's Structured Finance Special Comment (May 2009):
   Comparing Bank, US CMBS and Life Insurance Company Commercial Real Estate Expected Loss and Delinquency Rates
c. ACLI's Investment Bulletin (Fourth Quarter 2009): Mortgage Loan Portfolio Profile

These three studies highlight the delinquency and loss experience for the CREM market (Insurers, CMBS, and Banks) and provides context for the loss experience of life insurers' portfolios and investment practices compared to the overall market. A few statements highlight the conclusions:

- Losses on the U.S. life insurers' CML portfolios will be much less than for bank CMLs or CMLs within CMBS deals, as insurer loans are well-diversified by geography and property-type, conservatively underwritten, well-laddered by maturity, and seasoned loans on fully-stabilized and leased properties. (Moody's Insurance Special Comment)
- The limited amount (~$28-$36 billion or ~10%-12% of portfolio annually) of life insurers' CMLs maturing over the next two years during the trough of the real estate market when values are depressed and financing is constrained will moderate the losses. (Moody's Insurance Special Comment)
- Potential losses at loan maturity will be mitigated because of life insurers' ability to work with borrowers to extend or refinance loans. (Moody's Insurance Special Comment)
- Insurer rates for delinquencies and loans in process of foreclosure were on average 0.6% for 2008 and 2.1% for 2009. In other words, on average, 2.1% of *insurers'* commercial mortgage portfolios were delinquent or in the process of foreclosure in 2009. These rates represent gross delinquencies, not net losses, for life insurers submitting data to the ACLI's Quarterly Study (approximately 80% of the life insurance industry's total mortgage exposure). Note that the impact of delinquencies on insurers' capital would be offset by restructurings and other techniques that offset the loss of principal. By

> comparison, at the end of 2008, approximately 1.7% of the commercial mortgage portfolios for *banks* were in default or in process of foreclosure and rising to nearly 3.5% by the end of the third quarter, 2009. (Moody's Insurance Special Comment)

One explanation for better delinquency experience for life insurers is that the composition of insurers' CREM portfolios is different from the overall CREM market. Generally speaking, life insurers invest in and hold CREMs for the long term in their portfolios. Also, life insurers tend to follow tighter underwriting practices, compared to other participants in the commercial real estate market. Commercial banks and investment banks tend to make more front-end construction loans for properties that will likely be re-packaged into Commercial Mortgage Backed Securities (CMBS). As a result, life insurers hold more seasoned, stable loans that have been purchased with the intent of being held in the portfolio for the long term. In summary, the investment practices of life insurers tend to lead to lower expected loss rates compared to the aggregate CREM market.

Inconsistency with the Basis for RBC Factors

The CADTF proposal would make an adjustment that is inconsistent with the underlying basis for the current RBC factor. *RBC is intended to capture excess risks above those risks anticipated and covered in product pricing and reserves. RBC factors are not intended to provide the total cushion against loss. Further, RBC factors are used in a point-in-time calculation and are designed to capture losses over multiple years where losses will fluctuate with economic conditions.*

The current pre-tax factor for mortgages in good standing is 2.6% of carrying value. This 2.6% pre-tax factor has been in the RBC formula since statutory codification was completed in 2001. Relative to delinquency experience, it is easier to evaluate delinquency experience to the pre-codification factor of 2.25%.

This 2.25% factor was based on a study of commercial mortgage *loss* experience for loans between 1986 and 1989, updated for loss experience in 1994. The study included an analysis of loss experience and projection of future losses under stress scenarios. The mortgage model's key assumptions include incidence or default rates (i.e., the probability of moving from a good standing to a non-good standing status), the severity of loss upon incidence, and the variation in the incidence and severity as loans exhibit both better and poorer experience over a mortgage loan experience cycle. The 2.25% represents the expected loss in stress or tail scenarios over a mortgage life cycle. The average life cycle in the study was nine years. The 2.25% loss factor was chosen to cover scenarios at the 94th percentile. Further, the factor corresponds to a delinquency rate of 2.02% and a loss severity of 30.13%. The delinquency and loss severity represent average rates over the entire mortgage loan cycle. The average delinquency rate varies significantly by market state ranging from 0.30% in a favorable market to 4.75% in a stressed market.

At this time, there isn't evidence to suggest that current experience will be worse than the experience that formed the basis for the current RBC factor. The proposed 4% RBC factor for mortgages in good standing would put the CREM asset class on par with NAIC Class 3 bonds, or BB rated bonds. The current RBC factor was based on underlying experience that is far worse than insurers have been experiencing though 2009. A severe loss scenario would need to be anticipated to justify a 53% increase in the current RBC factors.

Introduction of Pro-cyclicality to the RBC Formula

Reserves include measures of anticipated experience plus a margin for uncertainty (estimation error and adverse deviation). RBC is intended to cover adverse experience in excess of that covered in reserves. Both reserves and capital provide for risks over a span of economic cycles. The CADTF proposal is attempting to increase capital requirements for losses above those already anticipated in reserves and existing capital requirements. The AIAWG thinks it is inappropriate to increase the RBC requirement unless there is strong evidence to suggest that there has been a permanent deterioration in loss experience over the entire cycle. As we have documented, current experience does not suggest a systemic deterioration in the entire commercial mortgage market not already anticipated by the current RBC factors.

The current RBC framework is not designed to be pro-cyclical where capital requirements are increased as defaults increase and capital requirements decrease as defaults decrease. The purpose of NAIC RBC is the identification of weakly capitalized companies. RBC is intended to form the minimum capital necessary to cover potential losses. Insurance companies must maintain the minimum capital requirements at all times. RBC is not currently designed to be a rainy day fund whose level fluctuates with the business cycle.

Conclusions

The AIAWG understands the CADTF's concerns with the loss experience in the commercial mortgage market. However, based on an analysis of the losses assumed in the current RBC factors, we do not think a 53% increase in required capital is justified. We support additional analysis of the commercial mortgage market and the loss experience for the life insurance industry. We also support investigation of alternative methods for calculating RBC for mortgages. The mortgage market is now more diverse than when the current RBC factors were developed and a more sophisticated approach to loss estimation may be justified. The AIAWG is studying alternative approaches for capturing investment risk in the RBC formula. In the meantime, we look forward to discussing our comments with you.

Sincerely,

David Berger, FSA, MAAA, Co-Chair, AIAWG
Jerry Holman, FSA, MAAA, Co-Chair, AIAWG

Copy: Dan Swanson, NAIC
Nancy Bennett, Chair, Life Capital Adequacy Subcommittee